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ABSTRACT

The booklet lists and dispels 14 economic myths through a discussion of money, economic concepts, and the Federal Reserve System. The objective is to help secondary students or adults understand the economic system as related to money and banking. Topics focus on money, banking, gold and silver, credit, government role, financial concepts, and interest. For these topics historical background information is provided, terms and concepts are defined, relationships between government and the banks are pointed out, Federal Reserve functions and operations are outlined, and various types of banks are compared. Sample myths include "Money is simply coin and paper currency," "Gold and silver are the only perfect monies," "The Government reduces money's value by printing too much currency," "Checks are money," "Banks are part of the Government," "All banks are the same," "Wall Street banking interests established the Federal Reserve and control monetary policy," "The Federal Reserve controls the amount of currency in circulation," and "Banks borrow money from the Federal Reserve at the discount rate and lend the funds at a higher rate to make profit." Cartoon drawings illustrate the concepts discussed. (CK)

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Preface

Most of us acquire two types of knowledge—"school knowledge" and "folk knowledge." Folk knowledge is information and "wisdom" passed from generation to generation or acquired on the streets.

For example, we're often told that sitting in a draft will give us a cold. Science tells us the common cold results from a virus. Yet, still we change our seat to avoid a draft. We may acknowledge that drafts only contribute to lowering our resistance to infection, but we still blame the breeze rather than the bug.

So too, most of us hold certain economic misconceptions—folk knowledge containing a germ of truth and a plague of misconception, economic myths picked up by misreadings or the acceptance of "facts" from a friend or relative.

Few of us are immune to economic myths or misconceptions. If you don't think so, I bet you thought

I bet you thought . . .

by David H. Friedman

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Before reading this booklet, indicate whether each statement below is true or false. After, check your answers and rate yourself.

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Money is simply coin and paper currency. Money is any generally accepted medium of exchange, not simply coin and paper currency. Money doesn't have to be intrinsically valuable (valuable in itself), be issued by a government or be in any special form. In our past, items ranging from iron nails and dried codfish to gun powder and tobacco have served as money.

Anything people generally accept in exchange for items of value is money. Money also is a standard for measuring value and a means of storing purchasing power for future use. Any item that has these three traits is money.

Americans accept three types of money—coin issued by the Treasury, paper currency issued by Federal Reserve Banks, and checkbook balances (demand deposits) at banks.

In analyzing economic activity, many economists take a much broader view of money and include other money-like items immediately available to the public for spending, such as passbook savings and other funds deposited for specific time periods.

Demand deposits are the nation's most common form of money, comprising about three-quarters of all money in circulation. This checkbook money is bookkeeping money created mainly by the nation's commercial banks. Americans prefer using checkbook money because it performs as a more efficient medium of exchange than coin or currency for many transactions. Check writers have with one blank check the potential for spending small or large amounts. Since each check must be signed before funds are transferred, checkbook money cannot easily be stolen. In addition, cancelled checks provide written proof of payments. Since we prize convenience, safety and recordkeeping, it's no wonder that checkbook money is preferred.

Checkbook money works because people are confident in the strength, safety and prudence of the American banking system. Their confidence has been bolstered by Government regulation of commercial banks and Government deposit insurance. The check clearing and collection system of the Federal Reserve, the nation's central bank, has also made checkbook money highly acceptable by speeding checking account transfers nationwide.

We've been big check users for quite awhile. The move began in the post Civil War era, when bank deposits became the dominant form of money held. Today, if all payment transactions were counted, including those for stock, bond and real estate purchases, the dollar volume of check spending to coin and paper currency spending would be enormous.

Only about 3 percent of our money is in coins, and for every 10 cents in small change we keep, we hold about a dollar in paper money. As a nation, we hold only about $80 billion of cash, compared with $230 billion of checkbook money.

Only coin and currency are real monies because the Government says they're "legal tender."
Coin and currency are "legal tender," money the Government says has to be accepted if offered to settle a debt. But that approval doesn't make cash any more "real" than checkbook balances.

Until the 1860s, "legal tender" applied only to coin, yet even then we used more private bank notes and bank deposits as money than coin. Legal tender designation was given to certain Government-issued paper currency during the Civil War to win public confidence in the paper money. However, there has been no meaningful distinction between "legal tender" and other U.S. money since 1933, when Congress made all coins and currencies legal tender for all public and private debts.

Regardless of what any government says, money must have certain characteristics that make it acceptable. Without those traits, even "legal tender" cannot be successful as money.

Most early monies were not issued by governments. They were commodities, such as salt, cattle and rum, that were widely known and easily sold or used. But commodities proved less than perfect monies. The tobacco used by the early Virginia settlers is an example.

The leaves weren't easily divisible, causing difficulty in "making change." The varying prices for different grades of tobacco made value difficult to determine. It also was hard to carry and store. Temperature and humidity changes caused flaking which "devalued" the leaves. In short, tobacco lacked many characteristics needed to make it work well as money.

For an item to perform successfully as money it must be durable, divisible, portable and difficult to counterfeit. More important, as the Virginians' experience shows, while any item can serve as money, it won't work well or last long unless it can also serve well as a standard and store of value.

People's willingness to accept money, in any form, is rooted not in the law but in money's ability to effectively measure and hold value.

Gold and silver are the only perfect monies. Gold and silver monies have been used for thousands of years, but they are far from perfect. Gold and silver always have been desired. The scarcity, luster, and almost mystical appeal of the metals made gold and silver acceptable as jewelry, armor and religious symbols. Gold and silver's use as commodities, and people's desire for them, established the acceptability of precious metal money centuries ago.

But precious metal, like all "commodity" monies, proved less than perfect. Coins were heavy and accumulation posed problems of safe transport and storage. Coins also could be remelted, mixed with common metals, and restruck, which reduced their intrinsic value. Gold and silver were scarce and demand for them generally exceeded supplies. As a result, the value of precious metal was generally high relative to common metals.

The history of American coinage deals largely with attempts to resolve problems of precious metal money.

For example, Congress issued paper money during the American Revolution because it lacked gold and silver coins and the metal to make them. In the 1870s, the U.S. allowed people to exchange silver dollars for paper dollars because the weight and size of the coins made them unpopular and little used. In the late 1960s, rising industrial demand forced silver's elimination from U.S. coinage.

Today's U.S. coins don't contain precious metal. The face value of our coins is greater than the value of the metal in the coins. We accept coins as "token" or "convenience" money for the small financial transactions of daily life, such as vending machine purchases, phone calls and tips.

The use of paper currency grew directly out of the problems of coins. The inconvenience of carrying and safekeeping large quantities of coin caused people in different societies to exchange paper receipts for coins or bullion held in a national treasury or private bank. More important, paper money was often used to overcome the scarcity of precious metal coins.

Paper money, however, also proved less than perfect. The basic problem concerned its source. When money was predominantly gold and silver coin, governments were prevented from issuing more coin by the amount of metal in their treasuries, dug out of the ground, or obtained for goods sold to other nations. Without similar restrictions on currency, governments and banks could overissue, reducing the value of each note, and jeopardizing paper money's acceptability by making currency a poor store of value.

During the American Revolution, Congress so overissued continental currency its value almost disappeared. Indeed, the expression "not worth a continental" was widely used then to connote worthlessness. The colonists were so angered that, after independence, Congress didn't issue paper money for over 70 years, even though it had the Constitutional power to "coin money" and "regulate" its value.

Until the Civil War, state-chartered banks issued their own currency. In the early 1860s, as many as 10,000 different bank note issues circulated. Banks were pledged to redeem their notes for coin or bullion, but because many banks had only a fraction of the precious coin or metal needed for repayment, and because many were headquartered in remote regions, the value of their notes was suspect. The result was a chaotic currency system in which people sometimes accepted bank notes at less than face value.

Until after the establishment of the Federal Reserve System in December 1913, the U.S. didn't have an "elastic" currency, a currency whose supply could expand or contract as business activity and public demand changed.

Gold "backing" gives the dollar its value. Until 1968, U.S. currency had to be partially backed by gold. However, gold never gave the dollar its value. The dollar's value always has been determined by the amount of goods and services it can buy—its purchasing power.

Gold backing was required through most of U.S. history as a means of restraining Government overissuance of paper money and improving public confidence, and, therefore, the acceptability of paper money.

When the Federal Reserve was established, Congress required the 12 Reserve Banks to back their currency, known then as Federal Reserve Bank notes and today as Federal Reserve notes, with 40 percent gold and 100 percent "eligible paper" (short-term IOUs of businesses and farmers). The eligible paper requirement was reduced to 60 percent in 1917. Gold was bought from the Treasury. Eligible paper was obtained from commercial banks that presented these customer IOUs as collateral for loans. Essentially, only those IOUs representing commercial bank loans made to expand manufacturing or farm output were designated "eligible" as collateral by the Federal Reserve.

The backing requirements on Federal Reserve notes were designed to regulate currency issuance automatically to the pace of the economy's growth, since only increased business activity and bank lending could generate the collateral necessary for more note issuance.

Backing requirements were liberalized and reduced over the years, as we gained better insight into how the economy works and how money should be regulated.

By the 1930s, Congress allowed Reserve Banks to use assets other than eligible paper, such as U.S. Government securities, to back currency. By the 1940s, Congress slashed the gold requirement to 25 percent and in 1968 eliminated gold backing entirely.

Federal Reserve notes are still "backed" dollar-for-dollar by the assets of the Reserve Banks. About 85 percent of these assets consist of Government securities the Federal Reserve purchased over the years. The remaining 15 percent consists of gold certificates representing pledges against the Treasury's gold supply. Reserve Banks no longer have to use their gold certificates this way, but many still do.

Currency backing isn't relevant in today's economy. Currency cannot be "redeemed," or exchanged, for Treasury gold or any other asset used as backing. The question of just what assets "back" Federal Reserve notes has little but bookkeeping significance.

Money's value, however, is highly relevant. Maintaining the dollar's value means maintaining its purchasing power. Rising prices—inflation—reduce purchasing power; stable prices keep purchasing power strong.

Too much money results in excess spending. When consumers, businesses and governments spend excessively, they compete for the available supply of goods and services and force prices up. When prices rise, the purchasing power of money falls. To keep purchasing power strong, then, the supply of money must not increase too rapidly.

The Government reduces money's value by printing too much currency.
The Bureau of Engraving and Printing in Washington, D.C., a unit of the Treasury, is responsible for printing the nation's currency. But its orders to print come from the 12 Federal Reserve Banks, not the President or Congress. The Reserve Banks, not the Treasury, determine how much currency is printed, based mainly on estimates of commercial bank and public cash demands. Under this arrangement, the Government can't print more Federal Reserve notes to pay its bills or debts.

Since most U.S. money is checkbook money, the printing presses have little to do with the buying power of money. Maintaining money's value involves the Federal Reserve's control over commercial banks that create most checkbook balances.

The Federal Reserve does this in three ways. First, the Federal Reserve Act requires commercial banks that are members of the System to keep "reserves" as coin and currency in their vaults or balances at their district Reserve Bank. By raising the percentage of reserves that must be held, the Federal Reserve reduces banks' ability to create more money. Lowering reserve requirements increases banks' money creating ability.

Second, the Federal Reserve lends money, generally for only a day or two, to banks that belong to the Federal Reserve System. It charges them interest, called the "discount rate." Changes in the discount rate have the effect of making Federal Reserve loans more or less attractive to member banks.

The most important control is open market operations—buying and selling U.S. Government securities through a network of almost three dozen private dealer firms. When the Federal Reserve sells securities from its $100 billion portfolio, dealers pay with checkbook money that is taken out of circulation when the checkbook funds are transferred from the dealer's bank to the Federal Reserve. When the Federal Reserve buys securities, it pays with checkbook money, increasing money in circulation.

Credit cards are a new form of money.
Credit cards aren't a form of money, but a "deferred payment" device, a means of obtaining goods and services by promising to pay later. Credit card transactions are similar to loans.

When you use a credit card, the card company, sometimes an affiliate of a large bank, pays what you owe to the merchant directly and immediately. In time, you receive a bill from the credit card company which you can either pay fully, or partially, with cash or checkbook money. Until you pay, the credit card company is extending you credit for which you will pay interest after a short period. Many people, however, pay their credit card bills within the month billed and avoid interest charges.

Many credit cards carry a "credit line," a maximum amount the issuer will lend you. A $1,000 credit line allows you to accumulate $1,000 in unpaid purchases or cash advances. Credit lines are prearranged loans that become effective when used, an arrangement commonly used by large companies.

All bank lending depends on the availability of reserves, which are determined by the Federal Reserve. When the supply of reserves is small and credit card users draw on their credit lines, banks have to reduce loans to other customers. Commercial banks alone lent about $12 billion through credit cards and similar plans in 1976, about 10 percent of their loans to individuals that year.

Even though credit cards aren't money, they affect the way we spend money and, in that sense, are important to understanding people's purchasing behavior.

For this reason, some economists believe lines of credit given on credit cards should be counted as part of the nation's "money supply"—a technical measure of the funds the public has available for immediate spending. They argue that many important spending decisions are based not just on the amount of cash and checkbook money people have on hand, but on individuals' holdings of financial assets, such as savings deposits, stocks and bonds, as well as the availability of credit.

Checks are money.

Checks aren't money in themselves. They are simply order forms instructing banks to move checkbook deposits, which are money, from one account to another. Those checkbook deposits are bookkeeping entries, numbers on banks' ledgers and in their computers.

Banks don't keep cash in checking accounts and don't transfer currency or coin when acting on a check's instructions. Checkbook deposits are transferred between accounts and banks as bookkeeping entries only.

In 1977, the nation's 14,600 commercial banks held about $230 billion of checkbook deposits for individuals, businesses and governments.

CHECKING
ACCOUNT

Checkbook money is "created" by currency deposits.

Commercial banks create checkbook money whenever they grant a loan, simply by adding new deposit dollars to accounts on their books in exchange for a borrower's IOU.

Money creation bookkeeping isn't gimmickry. Far from it. Banks are creating money based on a borrower's promise to repay (the IOU), which, in turn, is often secured or backed by valuable items the borrower owns (collateral).

Someone obtaining an auto loan, for example, might use the new car as collateral. A home improvement loan might be secured by the value of the house being improved. Business loans may be secured by physical assets, such as machines, factories and inventories, or may be "unsecured," backed only by the company's earnings record and expectations or general credit worthiness.

Banks create money by "monetizing" the private debts of businesses and individuals. That is, they create amounts of money against the value of those IOUs.

To create money, however, banks must have "excess" reserves, funds exceeding those they are legally required to hold. Banks belonging to the Federal Reserve System must abide by the System's requirements. Banks that aren't members are subject to the reserve requirements of the state that chartered them.

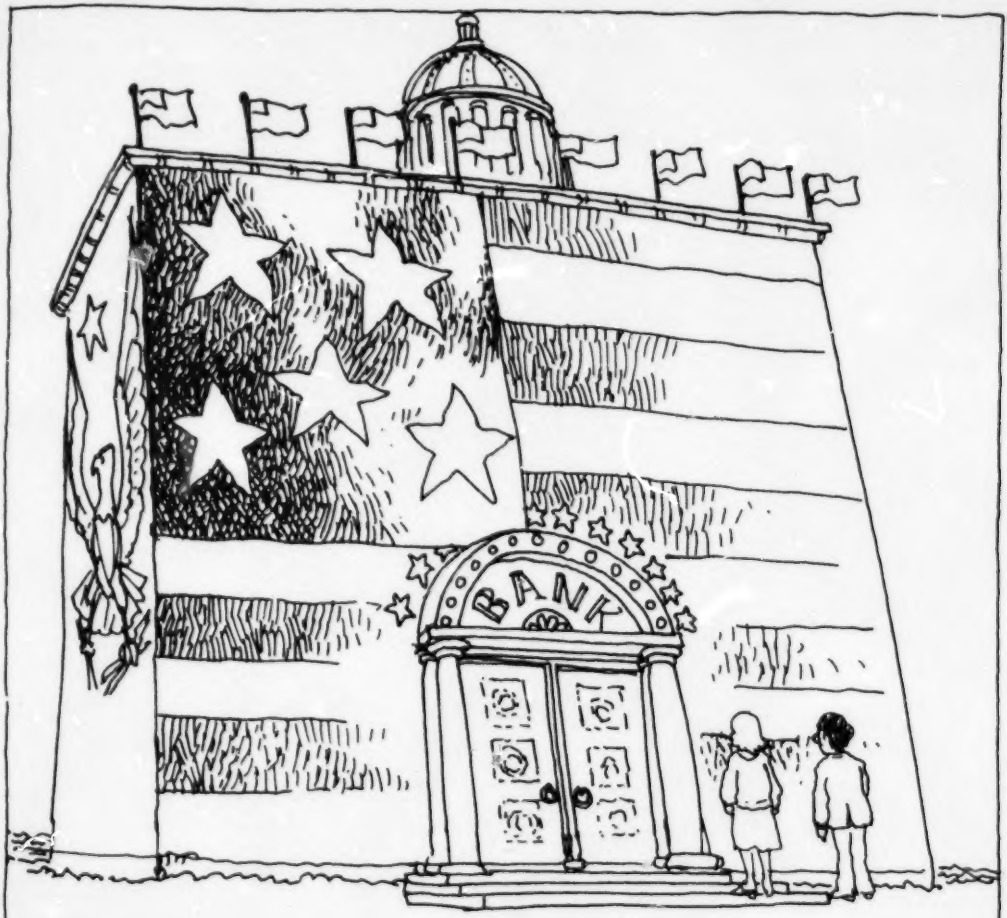
Even without legal rules, prudent banking dictates that some "required" reserves be held. Bankers know that, on any given day, they will have to pay out coin and currency to people cashing personal checks. They also know that they will have to transfer reserve balances as checks drawn against accounts they hold are presented for payment by other banks. Meeting these routine transactions requires that banks hold some reserve funds.

If a bank has excess reserves, it can create an amount of money equal to that excess; it can grant a loan. Borrowers write checks against their new deposits. When these checks are deposited at other banks, those banks collect payment from the borrower's bank. Bankers know that when other banks present borrowers' checks for payment, they will have to transfer reserves on a dollar-for-dollar basis.

If a bank creates an amount greater than its excess reserves, it also would lose some required reserves and face temporary violation of requirement rules. Prolonged violation of requirement rules subjects banks to penalties. So they tend to match lending to excess reserves. A bank short of required reserves usually will borrow from another bank. Member banks can also borrow from the Federal Reserve.

As newly created checkbook dollars move from bank to bank, banks gaining excess reserves can make additional loans. As a group, banks are capable of creating money in a multiple way. Currently, our banking system theoretically can generate a sevenfold increase in total money creation with a given amount of excess reserves.

Money multiplication, rather than currency deposits, accounts for most of our $230 billon of checkbook money. Banks hold only about $34 billion in reserves. Only $8 billion of that total is cash, the remaining reserves are deposit balances at Federal Reserve Banks. Reserves are the base on which the banking system has generated the bulk of the nation's checkbook money.


BANK

Banks are part of the Government.
Many banks carry very official-sounding names, like "Bank of America" and "State Bank of Albany," but they aren't run by, owned, or part of government.

Commercial banks are privately owned businesses trying to earn profits primarily by lending money to other businesses and to individuals. Don't get the wrong impression from the government-type seals on their windows.

Banks must be licensed to operate. The license, called a "charter," is given either by the Federal Government (Comptroller of the Currency) or the government of the state in which the bank wants to operate. Banks choosing Federal charters, about one-third of all commercial banks, must have the word "National" in their name or the letters "N.A." (National Association) after their title. State-chartered banks don't have to use the word "State" in their names, but many do.

Banks must meet government rules and regulations. Banks with Federal charters, for example, must join the Federal Reserve System, the independent agency Congress created to regulate the nation's flow of money and credit. State-chartered banks may join the Federal Reserve, an option chosen by only 10 percent of the nation's 9,800 state-chartered banks.

Banks belonging to the Federal Reserve may display a seal on their main window indicating they are a "member of the Federal Reserve System." Member banks are subject to many Federal Reserve regulations and can borrow money from Reserve Banks for short periods to meet unexpected customer withdrawals or other claims exceeding funds on hand. Federal Reserve membership doesn't make a bank a "member" of the Federal Government.

Regardless of charter, banks can join another "Federal" organization, the Federal Deposit Insurance Corporation (FDIC). Congress established the FDIC in 1933 to insure depositors against loss when a bank fails. Virtually all U.S. commercial banks are FDIC members. Most have a seal on their main door or near tellers' windows indicating that deposits are insured up to a maximum, which Congress sets, of $40,000 per account. But again, that "membership" doesn't mean the bank is part of, run by, or owned by the Government.

Most commercial banks in this country are small, locally owned businesses, with no branches, just a few employees, and only a few million dollars of deposits. Relatively few commercial banks are big businesses with many branch offices and thousands of employees. These big banks, however, hold a relatively larger share of the banking system's deposits than the small banks. Concentrated mainly in major cities, these big banks, like Chase Manhattan and Chemical Bank in New York City, and Bank of America in San Francisco, are owned by stockholders. Their ownership shares are bought and sold publicly on the stock exchanges.

Commercial banks try to earn profits for stockholders by lending money and by investing in Federal, state and local government securities. Most commercial bank loans are to businesses which need funds for such purposes as buying raw materials and modernizing factories.

Although many of the largest banks aim most of their advertising at consumers, only about $2.50 of every $10 lent by commercial banks are "consumer" loans. About $3.50 of every $10 lent are "commercial and industrial" loans. Real estate loans take about $3, and loans to financial firms, farmers, or others about $1 of every $10 lent.

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Banks are so powerful they can fix interest rates on loans and deposits and do just about whatever else they please.

Banks cannot do whatever they please. Their marketplace "power" and their ability to "fix" interest rates are highly restricted by overlapping layers of laws and government rules and regulations, and by active competition among banks and other financial institutions.

There are four Federal agencies that have bank regulatory responsibilities. Federally chartered banks are regulated by the Comptroller of the Currency, part of the Treasury Department that serves as the Federal Government's bank chartering agency. Since all federally chartered banks must belong to the Federal Reserve System, they are also subject to the central bank's rules.

Nonmember banks are regulated by both the chartering state government and the Federal Deposit Insurance Corporation. In addition, all banks are subject to the authority of the Justice Department, if their activities appear to violate antitrust laws.

The broad goal of government regulation of banks is to safeguard the public's money by making sure banks are operating prudently. Federal and state laws, for example, prohibit banks from investing in common stocks, and limit the maximum loan they can make to one borrower.

Furthermore, banks cannot open new branches, merge with other banks, affiliate with other businesses, such as credit card companies, or change business hours unless the regulatory agencies say okay.

In recent years, regulators have focused on bank lending and advertising practices. Recent legislation, for example, has aimed at eliminating racial and sexual discrimination in lending and requires that borrowers be informed of the precise conditions and terms of loans.

Commercial banks must conform to Federal and state laws on interest charged on some loans and interest paid on deposits. State "usury" laws set the legal interest rate limit on loans to individuals. State governments also determine maximum rates on residential mortgage loans and maximum rates state-chartered banks can pay on interest-earning (time) deposits.

In 1933, Congress prohibited commercial banks from paying interest on checking account funds (demand deposits). At the same time, Congress gave the Federal Reserve power to set ceilings on what member commercial banks could pay in interest on time deposits. Member banks, however, are limited to the maximum rates established by the states. Since the 1930s, the FDIC's interest rate ceilings have matched those imposed by the Federal Reserve and since 1972, so have all state ceilings. All commercial banks, then, have the same interest rate limits.

Commercial banks, however, do not charge the same rates for similar loans or pay the same rates for similar deposits. Commercial banks actively compete against each other and against "thrift institutions"—savings banks, savings and loan associations and credit unions—for deposits and many types of loans.

It is not uncommon for banks in the same area to have different automobile, home improvement or mortgage loan rates, different rates on savings and time deposits and different charges for financial services, such as money orders, personalized checks, and checking accounts.

CREDIT UNION
SAVINGS & LOAN ASSOC.
COMMERCIAL BANK
MUTUAL SAVINGS BANK

All banks are the same.

"Savings" and "commercial" banks differ in many respects. First, they have different corporate forms. Savings banks are "mutually" owned by depositors, not stockholders. They are run by nonsalaried boards of trustees, not corporate directors. Earnings aren't paid to private owners as dividends but distributed to depositors as interest on savings.

Savings banks collect individuals' savings and channel those funds mainly into home mortgages. Commercial banks take demand deposits and make profits by lending and investing.

The ability of thrift institutions to lend money for mortgages is linked to depositors' savings behavior. Many people deposit money in thrift institutions because they offer a good interest return on savings. However, when interest rates rise in the nation's credit markets, better returns often can be obtained by putting savings elsewhere. Fewer deposits mean fewer mortgages, and fewer mortgages generally lead to less home building and more unemployment in the construction trades. In addition, many industries that depend on a strong housing market, such as furniture and appliance makers, also suffer from reduced sales.

In the 1960s, Congress established a further distinction between savings banks and commercial banks by allowing thrift institutions to pay savings depositors a rate above the ceiling imposed on commercial banks. This small rate differential was designed to keep thrift deposit inflows strong enough to buttress the mortgage and housing markets.

One critical difference between savings and commercial banks traditionally has been in the way they lend money. Commercial banks lend by creating new checkbook deposits. Savings banks and similar thrift institutions simply pay out existing funds left by depositors.

In recent years, many states, particularly in the Northeast, have changed their laws to lift restrictions confining thrift institution operations mainly to accepting savings deposits and granting mortgages. Thrifts in more than 20 states can now provide some form of checkbook-type account.

Most of these accounts, however, don't hold newly created checkbook money, but rather the savings that depositors have transferred into them to pay bills. These accounts comprise only a fraction of the nation's total checkbook deposits.

If thrift institutions obtain broader powers to make loans other than long-term mortgages, they undoubtedly would begin creating money in much the same way as their commercial bank counterparts, by adding new deposit dollars to checking accounts. For now, most thrift institutions pay out loans with special checks against funds on hand, or funds deposited at a commercial bank, not by creating new demand deposits.

Wall Street banking interests established the Federal Reserve and control monetary policy. In 1913, the most vocal opposition to the Federal Reserve came from the Wall Street banking community. In part, that opposition stemmed from the intent of Congress to establish the Federal Reserve with built in "checks and balances" specifically to insure that monetary policy-making would be decentralized and made in the broad national interest. The System's structure, organization and relationship to Congress make it impossible for any interest group to dominate monetary policy.

The Federal Reserve System consists of three interlocking parts — a seven-member, Washington-based Board of Governors, 12 regional Reserve Banks, and 5,800 member commercial banks.

The Board of Governors is a Government agency. Each Governor is appointed to a 14-year term by the President of the U.S. with the advice and consent of the Senate. Terms are staggered for an appointment every two years. By law, Governors must come from different regions of the country, and "fair representation" must be given to financial, agricultural, industrial and commercial interests in their selection. Only two of the present Governors have substantive banking experience. Four are economists and one was a corporation president.

The 12 regional Reserve Banks aren't Government institutions but corporations nominally "owned" by member commercial banks, who must buy special, nonmarketable stock in their district Federal Reserve Bank. Each Reserve Bank has nine directors, each of whom serves three-year staggered terms. As stockholders, member banks elect the majority of the directors (six) but only three bankers can serve on a board.

The Federal Reserve Act requires that three directors of each Reserve Bank be appointed by the Board of Governors. They may not be bankers. Of the six elected directors, three must, by law, be actively engaged in some commercial, agricultural or industrial job. The Federal Reserve Act also prohibits the six "nonbanking" directors from being affiliated with a bank in any way. Thus, the nominal "owners" of the Reserve Banks, the private member commercial banks, have only three of the nine directors' seats at each Reserve Bank.

Moreover, the three banking directors must be representative of the entire banking industry, not just the big banks. Member commercial banks vote for their directors according to size, with small, medium and large banks each electing one banking director. Thus, the most powerful banks cannot dominate the banking directors.

In the 1970s, the New York Reserve Bank's directors have included chairmen and presidents of corporations and banks throughout the New York Federal Reserve District. But educators, a civil rights activist, law firm partners, and the president of a philanthropic organization also have been recent New York Reserve Bank directors.

Reserve Bank directors appoint Reserve Bank presidents, who serve with the Board of Governors on the System's key policy-making body, the Federal Open Market Committee (FOMC). Directors' appointments of presidents, however, must be approved by the Board of Governors.

The FOMC--which meets monthly in Washington, D.C. to decide the course of monetary policy, consists of all seven Governors and five Reserve Bank presidents, four of whom serve one-year terms on a rotating basis. The president of the New York Reserve Bank, who traditionally serves as FOMC vice chairman, is the only Reserve Bank president who serves as a permanent Committee member.

FOMC decisions aren't secret. A summary of the deliberations and record of policy actions are made public about 30 days after each meeting. A record of the vote of each member of the Committee appears after the formal policy decision, called the "directive." Dissenting votes are recorded with the reasons for the dissent. The 30-day delay is designed to avoid creating excessive reactions to policy moves that might hinder the functioning of markets and the orderly implementation of policy decisions.

What's more, the chairman of the Federal Reserve Board of Governors formally reports to Congress every three months on the course of monetary policy and the Federal Reserve's long-term objectives. In addition, System Governors routinely testify on key economic and banking issues before House and Senate committees.

The Federal Reserve is unique among government-type institutions in that it is "independent" within the Federal Government. Congress specifically structured the Federal Reserve so that monetary policy judgments and actions would be made nonpolitically. The 14-year term for System Governors is an example of that intent.

Neither the System's monetary policies nor its banking activities are designed to guarantee profits for anyone.

Almost all Federal Reserve earnings come from the interest paid by the U.S. Government on the $100 billion or so of Government securities the System acquired over the years for monetary policy purposes.

So far, in the 1970s the System earned more than $5 billion a year. Almost all of the Federal Reserve's earnings are returned to the U.S. Treasury. Funds retained by the System are used to pay the budgeted expenses of the Reserve Banks and the Board, maintain a small surplus, and pay the 6 percent statutory dividend on the Reserve Bank stock held by member banks. Member commercial banks don't share in the System's earnings.

F. R.

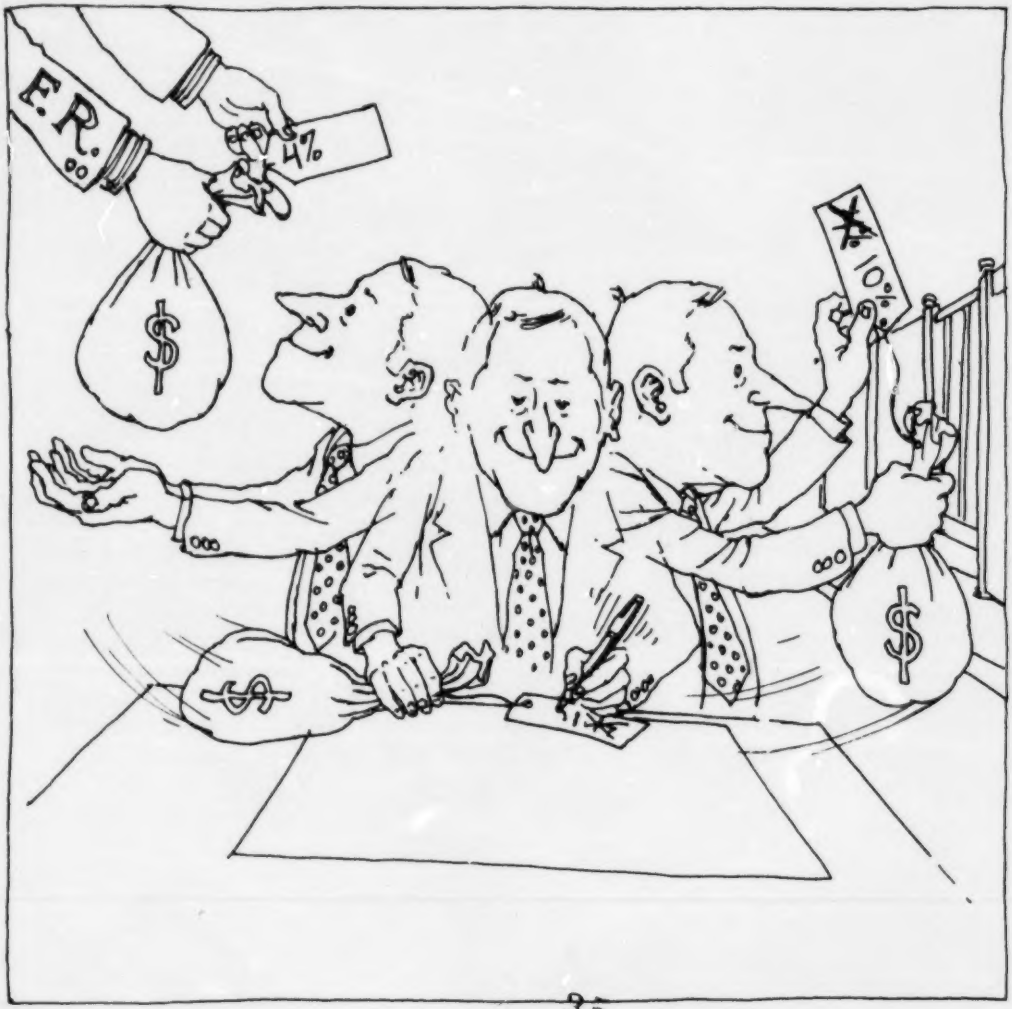
The Federal Reserve controls the amount of currency in circulation.

The Federal Reserve doesn't control the amount of "currency" in circulation. The public does. The Federal Reserve, however, determines the total amount of "money" in circulation.

When people want more currency, they cash checks at their banks. When banks want more currency, they purchase it from their Reserve Bank with the checkbook money they have on deposit as part of their required reserves. Since currency in circulation increases only when checkbook deposits decline, the total amount of money remains unchanged. Only the composition of the money supply changes when the public alters the form in which it holds money balances.

The public has shown, over the years, a very strong preference for checkbook money over cash. At particular times of the year, however, such as in December, this long-term preference shifts decidedly toward cash, and more than $2 billion in currency and coin leave the banking system. In January, demand shifts back to checkbook money, and cash returns to the banking system.

The Federal Reserve doesn't try to alter public preferences, but accommodates them by selling currency to banks to meet public demands and accepting currency deposits to reserve accounts as demands slacken.


E.R.
4%
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Banks borrow money from the Federal Reserve at the discount rate and lend the funds at a higher rate to make profit.

Banks can't borrow money from the Federal Reserve to lend at a higher rate, even if they want to. The Federal Reserve, not commercial banks, determines the rules for borrowing at the discount rate. These rules restrict borrowing to short-run, temporary, seasonal or emergency needs. Banks that borrow too much, too often, for too long, or for the wrong reasons, will soon hear from the Federal Reserve. Because banks know the rules and understand the Federal Reserve's fundamental central bank role as a "lender of last resort," they rarely try to abuse the borrowing privilege.

Commercial banks get the reserves that support their loans and investments by attracting individual and corporate funds with interest payments on time deposits, by borrowing reserves from other banks, or by selling assets, such as Government securities.

When the Federal Reserve was established, the workings of the economy weren't as well understood as today. In those days, banks could readily replenish the funds they lent to farmers and to businesses engaged in buying raw materials and manufacturing finished goods by borrowing from the Federal Reserve. Economic theory indicated that, since "commercial loans" helped increase production and create more jobs, accommodating banks would help feed economic expansion. To encourage the additional lending and spending that would generate expansion, the discount rate would be reduced. To discourage lending, the rate would be raised.

Today, the Federal Reserve no longer follows the "commercial loan theory" of discount lending. Lending at the discount rate is now used as a "safety valve" that provides funds to individual banks only when necessary.

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